

# DOCKET SECTION

BEFORE THE  
POSTAL RATE COMMISSION

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DOCKET NO. R97-1

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POSTAL RATE AND FEE CHANGES, 1997

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REPLY BRIEF OF  
UNITED PARCEL SERVICE

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United Parcel Service ("UPS") submits this reply brief to respond to a number of the arguments made by the United States Postal Service ("Postal Service") and other parties in their initial briefs. We do not respond to every argument -- we have already dealt with many of them in our initial brief -- but rather discuss only those assertions which seem most likely to mislead the Commission concerning UPS's position or the evidence in the record.

ARGUMENT

I. DESPITE THE POSTAL SERVICE'S RECENT FINANCIAL SUCCESS, THE RATES FOR AT LEAST SOME SUBCLASSES MUST BE INCREASED TO AVOID VIOLATING THE STATUTORY RATEMAKING REQUIREMENTS.

Some parties have argued that the Postal Service's rate request should be denied in its entirety because of, among other things, the Postal Service's recent financial success, including indications that the Postal Service will experience a substantial surplus in FY 1998, the test year. See, e.g., Initial Brief of Alliance of Nonprofit Mailers at 2-9. See also Office of the Consumer Advocate Initial Brief, First Section (dated March 16, 1998).

UPS, too, is concerned about the Postal Service's request for substantial additional revenues that would come largely from its monopoly letter mail services -- especially its request for an increase in the rates for First Class letter mail -- in the face of the Postal Service's recent, and apparently continuing, financial success. However, there is no doubt on this record that, despite the Postal Service's overall financial well-being, the existing rates for at least some classes of mail are now below cost, or are substantially below the level needed to meet the contribution to institutional costs for the subclass established by the Commission in Docket No. R94-1.

For example, Parcel Post rates clearly must be increased. Those rates are now insufficient to cover attributable costs. USPS-T-37 at 24; Exhibit USPS-15G. In fact, Parcel Post rates were below properly determined attributable costs in FY 1997. Exhibit USPS-15D; Tr. 25/13570-71. Parcel Post has had a history of repeatedly falling below attributable costs, Tr. 8/4227, undoubtedly because of its razor thin cost coverage. Not to increase Parcel Post rates in this proceeding would clearly violate section 3622(b)(3).

Similarly, in the absence of a rate increase, the Postal Service's estimate (which understates volume variable costs) indicates that Priority Mail's cost coverage will fall to 179% in the test year. USPS-T-30 at 42 (Exhibit USPS-30A).<sup>1</sup> This is substantially below the coverage of 197% established by the Commission in Docket No. R94-1. Postal Rate and Fee Changes, 1994, Docket No. R94-1, Opinion and Recommended Decision at V-36 ("R94-1 Opinion"). In FY 1999 -- just a few short months away -- Priority Mail's cost coverage will inevitably deteriorate even further,

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1. Properly calculated -- i.e., increasing Priority Mail's test year attributable costs to reflect (1) 100% volume variability for mail processing labor costs and (2) Mr. Takis' non-volume variable incremental costs -- Priority Mail's test year cost coverage is actually far less than 179%.

especially in light of the substantial additional costs the Postal Service is incurring as a result of the establishment of the PMPC network.

In short, in evaluating arguments that the Postal Service does not need an overall systemwide rate increase, the Commission must also separately evaluate the circumstances of each mail service.

II. THE POSTAL SERVICE'S "COMPREHENSIVE COSTING FRAMEWORK" IGNORES THE STATUTORY REQUIREMENT THAT EACH CLASS OF MAIL MUST BEAR ITS ATTRIBUTABLE COSTS PLUS A PORTION OF THE REMAINING UNATTRIBUTED COSTS.

UPS agrees with much of what is said in the Postal Service's brief concerning the economic principles that should assist the Commission in implementing the ratemaking requirements of the statute. However, the Postal Service fails to properly relate these economic principles to the statutory requirements.

For example, the Postal Service and all of its experts agree that Dr. Takis' incremental costs are, on this record, the best estimates -- indeed, they are the only estimates -- of the "costs caused by provision of the entire volume of a particular subclass of service." Postal Service Initial Brief at III-2, citing Dr. Panzar. See also Postal Service Initial Brief at III-8 ("As Dr. Panzar and Mr. Takis testify, incremental costs are properly measured as the cost that would be avoided if the entire volume of a subclass were to be eliminated"). The Postal Service also agrees that "it would be clearly inappropriate to consider the sum of volume variable and 'specific fixed' costs as the full measure of causally related costs, when Mr. Takis' results plainly show that not to be the case." Postal Service Initial Brief at III-8. Yet, the Postal Service persists in arguing that some of the incremental costs of a subclass -- those that are not volume variable -- may be "reasonably assigned" on the basis of the non-cost factors of the

statute. It does so despite its recognition that the "second tier" of the "postal ratemaking process established by Congress" -- "the pricing exercise" -- was intended "to determine how much total revenue to seek from each subclass, in excess of the costs determined to be caused by that subclass during the first-tier costing process . . ." Postal Service Initial Brief at IV-1 (emphasis added).

The Postal Service's refusal to acknowledge the implications of its own witnesses' testimony is inexplicable, in light of its agreement that Congress intended to ensure that the attributable cost "rate floor" would be calculated so as to include "all costs that were, but only those costs that were, causally related to the provision of the subclass in question," and that, "[b]eyond that," the Commission "is to assign remaining costs reasonably on the basis of the other eight factors set forth by § 3622(b)." Postal Service Initial Brief at IV-14 to IV-15 (emphasis added), citing National Association of Greeting Card Publishers v. U.S. Postal Service, 462 U.S. 810, 830-32, 834 (1983) ("NAGCP-IV").

The Postal Service's resistance to marking up incremental costs even though incremental costs are "caused by" and are therefore "attributable to" the various classes of mail is based in large part on a claim that marking up incremental costs "Would Lead To The Loss Of Essential Cost Information." Postal Service Initial Brief at IV-65. But that is just not so. As Dr. Christensen testified, it is necessary to measure marginal costs as a step on the way toward measuring incremental costs. Tr. 34/18291-92. Thus, the marginal cost information which the Postal Service fears will be lost will in fact be separately calculated and will be available for use in the roll-forward process, or for any other appropriate purpose.<sup>2</sup>

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2. The Postal Service (Initial Brief at IV-70 n.48) criticizes Dr. Henderson for stating that, "As a general matter, in the absence of decreasing returns to scale long run incremental costs will always be at least as great as short run incremental

*(Footnote continued to next page)*

The only other use for this information which the Postal Service cites is to determine "the degree to which different rate combinations deviate from economically efficient rates" -- that is, rates determined by Ramsey Pricing. Postal Service Initial Brief at IV-68. Despite the continuing emphasis which the Postal Service and certain other parties continue to place on Ramsey Pricing, the argument "over the theoretical virtues of Ramsey prices in promoting economic efficiency is simply irrelevant" here. Tr. 25/13561 (Dr. Henderson). Ramsey Pricing is not appropriate for postal ratemaking because the higher elasticities of the letter mail classes result from legal restrictions on the delivery of letter mail rather than from consumers' freely-made decisions concerning the value of those services to them. See Tr. 25/13561-62. Moreover, the other reasons previously cited by the Commission for rejecting Ramsey Pricing as "inappropriate . . . as a representation of economically efficient rates," Postal Rate and Fee Changes, 1987, Docket No. R87-1, Opinion and Recommended Decision at 377 (¶ 4058) ("R87-1 Opinion"), still apply. Tr. 25/13561-62.<sup>3</sup>

Thus, the Postal Service's "economic" arguments for not marking up incremental costs are not sound. In any event, as stated in UPS's initial brief (at pages

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*(Footnote continued from previous page)*

costs." Tr. 25/13626 (emphasis added). But, as Mr. Takis' numbers show, it is certainly the case here that incremental costs are, for every subclass and service, "at least as great as short run incremental costs." Moreover, Dr. Christensen agreed on cross-examination that the only situation other than decreasing returns to scale in which long run incremental costs may not be as great as short run incremental costs is where the firm in question has insufficient capacity. Tr. 34/18270-71. That possibility is precisely why Dr. Henderson prefaced his statement with the phrase, "As a general matter."

3. The Postal Service asserts that the data used in Ramsey Pricing are the same data that have been used to forecast volumes. Postal Service Initial Brief at IV-25. The Commission has already rejected this argument as a basis for implementing Ramsey Pricing. See, e.g., R87-1 Opinion at 372-77 (¶¶ 4042-4058).



11-12), the clear congressional intent expressed in the plain language of the statute, not the views of the Postal Service's economic experts, controls here.<sup>4</sup>

Finally, the Postal Service argues that Dr. Henderson's use of the Commission's Docket No. R94-1 markup relationships is "not consistently based on prior Commission methods" because the Commission has never had before it an attributable cost base which includes incremental costs. Postal Service Initial Brief at IV-70 to IV-71. But the Commission has always marked up all attributable costs, even though the costs included in the attributable cost base have differed from case to case as a result of improvements in costing methods.

In this case, including incremental costs in the attributable cost markup base increases that base by approximately \$1.1 billion.<sup>5</sup> On the other hand, the Postal Service's proposal to reduce attributable mail processing costs by approximately \$3.5 billion represents a change in the markup base that is three times greater than the change that results from including all incremental costs in the base.

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4. That the views of the Postal Service's experts are inconsistent with the statutory requirement that "all costs reliably identifiable with a given class, by whatever method, be attributed to that class," NAGCP-IV, 462 U.S. at 820 (footnote omitted) (emphasis added), is clear from the Postal Service's assertion, in reliance on Dr. Panzar's testimony, that sunk costs should not be attributed. Postal Service Initial Brief at III-9. In determining attributable costs under the statute, the relevant question is not whether a particular cost is a sunk cost, but rather whether the cost is caused by a subclass of mail. Costs caused by a subclass must be included in attributable costs even if they are sunk costs. It is just not fair for the users of other services to pay for the sunk costs of, for example, Express Mail.
  5. Dr. Takis adds \$1.4 billion to total volume variable costs to arrive at total incremental costs. Tr. 25/13565-66, 13585 (Exhibit UPS-T-3B). That includes \$0.3 billion of specific fixed costs, which have always been part of the markup base. Thus, using total incremental costs as the markup base in this case would increase that base by approximately \$1.1 billion compared to past practice.

In short, the statute directs that all costs caused by a class of mail be attributed to the class, and that a portion of all remaining costs be added on top of attributable costs to reflect the appropriate contribution of the class to institutional costs in light of the non-cost factors in the Act. Nothing the Postal Service or its experts may say can change that inescapable fact.

III. THE MISLEADING ARGUMENTS MADE ON BRIEF DO NOT REHABILITATE DR. BRADLEY'S FLAWED MAIL PROCESSING ANALYSIS.

The Postal Service's argument that attributable mail processing costs should be drastically reduced is based almost exclusively on a set of complex equations that measure the wrong thing. In particular, Dr. Bradley's mail processing presentation (1) is a short run rather than a long run analysis (2) that seeks to measure the relationship between piece handlings and hours rather than the impact of volume on costs.

The Postal Service states on page III-14 of its initial brief that "Dr. Bradley's overall conclusion is that mail processing labor costs are not fully variable with volume." That may be Dr. Bradley's "overall conclusion," but the fact is that he has not measured the impact of volume on costs. Even assuming away the serious questions concerning the reliability of his total piece handlings data, the substantial questions concerning the legitimacy of his data scrubs, and the fact that his analysis fails statistical tests of reliability, the most that Dr. Bradley's equations can arguably show is that mail processing workhours are not fully variable with total piece handlings.

The evidence clearly establishes that workhours do not capture the full effect of volume on costs. See, e.g., Tr. 28/15751-53, 33/17868-71. The evidence also

indicates that total piece handlings are not the same as volume. Tr. 28/15754-56.<sup>6</sup> Since Dr. Bradley used the wrong variables in his equations, his study is irrelevant to the central point in postal ratemaking -- the effect of volumes on costs.

Dr. Bradley's analysis hinges completely on the empirical question of the extent of the relationship between piece handlings and volume. Yet, the record in this proceeding is completely silent on this critical point. If piece handlings increase more than proportionately with volume, Dr. Bradley's analysis will understate the true volume variability of mail processing labor costs. Tr. 28/15599. Since Mr. Degen starts with Dr. Bradley's conclusions on the portion of mail processing labor costs that are variable (and therefore attributable), nothing he does can rectify such an error. Thus, even if the Commission were to overlook the many problems in Dr. Bradley's study, the absence of this critical link in the causal chain makes it impossible to base any conclusions regarding the volume variability of mail processing labor costs on that study.

The Postal Service's attempt (Initial Brief at III-35) to analogize Dr. Bradley's mail processing study with studies of city delivery carrier costs and volumes and with studies of purchased transportation costs and volumes is faulty. As Dr. Bradley himself pointed out (Tr. 33/17881), the city delivery carrier studies use "pieces handled" -- i.e., volume itself, expressed in pieces -- not piece handlings as the

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6. The Postal Service in its brief often glosses over the difference between mail volume and piece handlings by using interchangeably phrases such as "the total number of pieces handled," seemingly equating that term with "TPH," or total piece handlings. See, e.g., Postal Service Brief at III-12. Of course, there is a vast difference between the number of pieces of mail handled, and the number of times those pieces are handled. Dr. Bradley used piece handlings, not the number of pieces handled, in his equations. Tr. 28/15754-56.

independent variable.<sup>7</sup> Likewise, the purchased transportation study directly analyzes costs and volumes -- specifically, cube -- rather than a variable that is both conceptually and empirically distinct from volume, and whose relationship to volume is not known.

At several points in its brief, the Postal Service suggests that operational experts participated heavily in Dr. Bradley's analysis. See, e.g., Postal Service Initial Brief at III-18. When it makes these statements, it never furnishes any citations to the record. On the other hand, the testimony on rebuttal of the Postal Service's own mail processing operations expert makes clear that Dr. Bradley's workhours variable is not an adequate substitute for costs because workhours do not capture the full effect of volume on costs when, for example, volume causes overtime to be incurred. See Tr. 33/17868-71.

The Postal Service also mischaracterizes Dr. Neels' testimony, just as Dr. Bradley repeatedly did in his rebuttal testimony. For example, the Postal Service states, "Dr. Neels asserts both that labor hours vary 100 percent with volume and that costs vary 100 percent with volume." Postal Service Initial Brief at III-34, citing Tr. 28/15760, 15634. Examination of the transcript pages cited by the Postal Service shows that Dr. Neels did not so testify. Rather, the thrust of Dr. Neels' testimony is that Dr. Bradley's analysis of workhours and total piece handlings does not prove anything about the relationship between volume and costs.

Similarly, the Postal Service states (Initial Brief at III-36 to III-37), "Dr. Neels, in a surprising argument, implies that TPH is a poor cost driver," quoting part of

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7. Moreover, it is far different to use labor time as the dependent variable when one is analyzing the impact of volume on costs in the case of the activities of an individual city delivery carrier, as opposed to studying workhours for an entire activity embracing many employees for an entire accounting period.

Dr. Neels' testimony which contains no such implication (Tr. 28/15598). Again, Dr. Neels' point is clear and was simply stated in his direct testimony: "'Total Piece Handlings' Is Not a Suitable Proxy For Volume." Tr. 28/15598.

Indeed, the Postal Service itself does not seem to understand fully Dr. Bradley's testimony. For example, the Postal Service states that Dr. Bradley's threshold scrub was intended to eliminate "data for periods where a site is starting a new activity." Postal Service Initial Brief at III-60, citing USPS-T-14 at 30. However, Dr. Bradley's "threshold" scrub does far more than that -- it systematically eliminates low volume sites and low volume accounting periods, including instances where the activity in question clearly was not new but rather was in operation for some time. See Tr. 28/15770.

In fact, Dr. Bradley's analysis is at odds with Dr. Panzar's testimony. Dr. Panzar specifically testified that the appropriate test for cost causation purposes is to determine the impact on costs "that will actually be incurred by the firm to serve a sustained increased in volume over the time period during which the prices will be in effect." Tr. 9/4636 (emphasis added). Yet, Dr. Bradley's equations merely measure the impact of piece handlings on workhours over two accounting periods, i.e., eight weeks. Tr. 28/15781-82.<sup>8</sup>

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8. The Postal Service is inconsistent on how best to measure long run variability. In discussing mail processing costs, it argues that cross-sectional analysis is not an appropriate method for determining the long run impact of volume on costs. See Postal Service Initial Brief at III-65 to III-67; Tr. 33/17906-13. However, it extols the virtues of cross-sectional analysis as a method of determining long run variability when it argues in support of Dr. Bradley's purchased transportation cross-sectional analysis. Postal Service Initial Brief at III-167.

When all is said and done, the fact remains that Dr. Bradley's equations are largely irrelevant to the issue at hand. They certainly do not justify the substantial deviation from prior Commission practice that is advocated by the Postal Service.

**IV. THERE IS NO IMMUTABLE LINK BETWEEN DR. BRADLEY'S MAIL PROCESSING ANALYSIS AND MR. DEGEN'S DISTRIBUTION KEYS.**

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The Postal Service argues that only its mail processing variability and distribution results are based on a "coherent economic framework of causality," and that, as a result, it would be "inappropriate" to use Mr. Degen's distribution keys were the Commission to continue to attribute essentially 100% of mail processing labor costs. Postal Service Initial Brief at III-94, 122.

However, as shown in UPS's initial brief (at pages 30-33), there is no "immutable link" between Dr. Bradley's results and Mr. Degen's distribution methodology. In fact, the Postal Service's mail processing presentation is not as "coherent" or internally consistent as the Postal Service would have the Commission believe.

First, the Postal Service agrees that "the fundamental purpose of a variability analysis is to measure how costs vary with volume." Postal Service Initial Brief at III-29 to III-30 (citing Dr. Bradley at Tr. 33/17882). Yet, as we have previously pointed out, Dr. Bradley's equations deal only with the relationship between hours and piece handlings, not costs and volume. Even overlooking the fact that Dr. Bradley analyzed the wrong variables, Mr. Degen did not use the "cost driver" analyzed by Dr. Bradley (total piece handlings) to distribute mail processing costs by subclass; indeed, he could not do so, because, as Dr. Christensen acknowledged, total piece handlings are not available by subclass. Tr. 34/18221. Moreover, contrary to the impression the Postal Service seeks to create (see, e.g., Postal Service Initial Brief at III-36), Mr. Degen has not done any empirical investigation of the relationship between the "cost

driver" (total piece handlings) and volume. Instead, Mr. Degen relied on an assumption that total piece handlings are directly proportional with volume. Tr. 12/6598-6604. This is hardly a "coherent framework."

Dr. Christensen, the Postal Service's chief witness on the "link" between Dr. Bradley and Mr. Degen, agreed that if mail processing labor costs are actually 100% variable with volume, Mr. Degen's distribution methodology could still be used to distribute mail processing labor costs. Tr. 34/18258. It makes no difference whether the conclusion that mail processing labor costs are essentially fully volume variable is based on an econometric analysis or on some other basis. All that is needed to achieve the internal consistency that the Postal Service seeks is for the cost pools examined in arriving at the variability conclusion and those used in the cost distribution process to conform to each other. Given such conformity, there is no reason why the Commission must rely on Dr. Bradley's analysis as opposed to some other variability analysis, or even, in the absence of a defensible econometric analysis, on a logical, common sense conclusion that the mail processing labor cost pools are 100% volume variable. The attempt to argue otherwise is nothing more than a thinly disguised effort to avoid the consequences of applying Mr. Degen's substantial improvements in the cost distribution process to all mail processing costs.

The other attacks on Mr. Sellick's adoption of Mr. Degen's cost distribution approach are equally unfounded. For example, DMA criticizes Mr. Sellick's testimony that more eligible items were counted in this proceeding than in Docket No. R94-1, arguing that Mr. Sellick's figures exclude certain mixed mail categories such as empty items. DMA Brief at 21 n.14. DMA claims that "less than five percent of all mixed mail was actually counted." Id. However, the mixed mail categories Mr. Sellick excluded from his calculation are those that could not be counted and that never could

be counted. Tr. 26/14251, 36/19480.<sup>9</sup> Mr. Sellick's conclusion regarding the extent to which countable mixed mail has actually been counted in this case compared to the proportion that was actually counted in Docket No. R94-1 deals with comparable categories.

DMA also claims that the chi squared test conducted by Mr. Sellick establishes that distributing costs at the Basic Function level -- the approach used in LIOCATT but not by Mr. Degen (except for the non-MODS cost pools) -- is important because it supposedly shows that "the percentage of mixed items that were counted differed significantly by basic function" and the "subclass composition of mail differs by basic function." DMA Brief at 22. However, as Mr. Sellick testified on rebuttal (Tr. 36/19480-81), for one variant of the Basic Function variable -- the one used by LIOCATT -- the percentage of mixed mail items that were counted did *not* differ significantly at the commonly-used 95% confidence level. And in the case of mixed mail containers, the chi squared test found no difference by Basic Function in the incidence of counting versus not counting at the 95% confidence level. Tr. 36/19481-82. Finally, as Mr. Sellick testified, of the 14 variables included in the chi squared test, there were no significant differences in the incidence of counting for 11 of the 14 variables for mixed mail items and no differences in the incidence of counting for 13 out of 14 variables for mixed mail containers at the 95% confidence interval. Tr. 36/19481. In short, DMA's argument seriously mischaracterizes Mr. Sellick's testimony; the results of the chi squared test in no way suggest that LIOCATT is superior to the Degen/Sellick approach.

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9. DMA does not explain how one can count mail that is not in an empty item, for example.



DMA argues that stratification by cost pool does not mitigate the difference in counted versus uncounted proportions Mr. Sellick found by mail processing operation in his chi squared test. DMA Brief at 22-23. This claim also mischaracterizes Mr. Sellick's findings. The variable to which DMA refers is merely *related* to the mail processing operation; it directs the data collector to another question and is of no significance in and of itself. Thus, Mr. Sellick's test does not in any way support the conclusion that data collectors "are less likely to count items . . . found at equipment most likely to be processing First Class letters." DMA Brief at 23, citing R94-1 Opinion, ¶ 3046. The variables which actually describe the function performed by the sampled worker -- Manual or Mechanical Operation, Type of Manual Operation, Type of Allied Labor -- all pass the chi squared test, i.e., are not biased in any way for or against counting mixed mail. If DMA had bothered to look at Mr. Sellick's testimony and workpapers, it would have realized this and not made its erroneous claim.

DMA's assertions concerning data thinness on pages 24-26 of its brief are grossly misleading. In particular, DMA switches its basis of comparison in mid-sentence in an apparent attempt to confuse the reader. While DMA provides percentages of distribution cells where there are five or fewer tallies, only 5.7% of costs are distributed on the basis of five or fewer tallies. Tr. 36/19484.<sup>10</sup>

DMA also cites misleading coefficient of variation calculations. DMA Brief at 25-26. As Mr. Degen stated in his rebuttal testimony, Tr. 36/19335-36, coefficients of variation are not meaningful at the levels cited by DMA. Instead, the correct standard is the coefficient of variation of the final cost estimates. Tr. 36/19335. After all, the final cost estimate is all that ultimately matters. At that level, Mr. Degen's

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10. Less than 5% of costs are distributed on the basis of fewer than five tallies. Tr. 36/19484.

method shows only marginally higher coefficients of variation than does the LIOCAT method. Tr. 36/19336.

The Periodicals mailers claim that Mr. Sellick's adoption of Mr. Degen's distribution approach disregards causality in distributing mixed mail and not handling mail costs. Initial Brief of Alliance of Nonprofit Mailers, et al. at 26. Again, that is just not so. For most cost pools, causation is obvious. For example, mail handled at OCRs clearly causes the costs of mixed mail and of not handling mail observed at OCR machines.

Furthermore, Mr. Degen and Mr. Sellick distribute the largest of the allied cost pools -- Platform costs -- on the basis of all allied cost pools, not just on the basis of the observations in the Platform cost pool alone. If there is in fact some interrelationship between Platform costs and other allied costs that should be taken into account in the cost distribution process, the Degen/Sellick distribution method takes that interrelationship into account.

As Mr. Degen testified in his rebuttal testimony (Tr. 36/19331-32), the LIOCAT/Periodicals mailers' approach yields obviously incorrect results. For example, over 40% of the costs of mixed mail flats in the 1Canc MPP cost pool -- an allied cost pool that consists largely of cancellation operations -- would, under that approach, be distributed to Standard A mail and to Periodicals, subclasses which are not typically handled in that activity. Tr. 36/19332. Likewise, the 1Bulk pr cost pool relates solely to presort mail, the 1Scan cost pool consists only of mail using the Air Contract Data Collection System, and the 1SackS\_h cost pool consists solely of activities relating to mail sacks and outside parcels. See USPS-T-12 at 15 and Library References H-146, 147 (Appendix A). Yet, in each of these cases, the LIOCAT/Periodicals mailers' approach would ignore the fact that these allied cost pools are related to specific functions that are performed for specific subclasses or categories of mail, while the Degen/Sellick method makes use of this information to

distribute the costs in these pools to the subclasses undergoing those functions. In short, even in the case of allied cost pools, the Degen/Sellick distribution of costs within cost pool is more closely based on known relationships between the functions performed and the subclasses of mail on which the functions are performed than is the LIOCAT/Periodicals mailers' approach.

In the final analysis, the question before the Commission is which of the cost distribution methods available in this case more accurately reflects the extent to which different mail processing costs are incurred by different subclasses of mail. Those choices are LIOCAT (and the Periodicals mailers' variation on LIOCAT) or the Degen/Sellick distribution method. UPS submits that, for the reasons given by Mr. Degen and by Mr. Sellick, the new approach proposed by the Postal Service as modified by Mr. Sellick is superior to LIOCAT, regardless of whether Dr. Bradley's analysis is adopted by the Commission.

V. DR. HENDERSON'S RECOMMENDED COST COVERAGES SHOULD BE ADOPTED BY THE COMMISSION.

A. *Priority Mail*

The Postal Service urges the Commission to reject the rate increase for Priority Mail which Dr. Henderson found to be necessary to cover Priority Mail's attributable costs and preserve the markup relationships the Commission established in Docket R94-1. It does so on the ground that Dr. Henderson's recommended increase is based largely on marking up incremental costs and on treating mail processing labor costs as fully volume variable. Postal Service Initial Brief at V-115. It does not attack

Dr. Henderson's proposed Priority Mail cost coverage of 193%. See Postal Service Initial Brief at IV-40 to IV-42.<sup>11</sup>

NDMS, on the other hand, argues that Priority Mail's cost coverage is overstated on the ground that Priority Mail "suffers from chronically poor delivery performance." NDMS Brief at 64. The Commission has rejected this same claim in the past because such evidence "does no more than elaborate on considerations previously incorporated in our analysis of the appropriate level of contribution for the priority mail subclass." Postal Rate and Fee Changes, 1990, Docket No. R90-1, Opinion and Recommended Decision at IV-24 (¶ 4075). Absent some indication that Priority Mail service performance has significantly deteriorated since Docket No. R94-1, the markup relationship established by the Commission in that case already implicitly reflects the Commission's evaluation of the service accorded Priority Mail, to the extent the Commission deems actual performance to be relevant.

Intrinsic value of service is best taken into account by comparing service standards rather than the extent to which those standards are actually achieved. That is sensible because:

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11. Dr. Henderson's recommended cost coverage is virtually identical to that proposed by the Postal Service. As the Postal Service notes in its brief (at pages IV-40 to IV-41), the Postal Service's original proposed cost coverage was 198%. That proposed coverage was reduced when the Postal Service discovered that it had understated Priority Mail's volume variable costs by approximately \$71 million. Tr. 4/2135-36. This manipulation of cost coverage so as to negate an admitted increase in Priority Mail's attributable costs belittles both the costing process and the pricing process required by the statute. It is a result-oriented approach that changes the allocation of institutional costs meant to be based on the non-cost factors of the statute to compensate for a change in attributable costs. In short, it improperly collapses the two-step ratemaking process required by the statute into a one-step approach that denigrates the notion of an attributable cost rate floor.

1. Service standards differ for different subclasses, so that actual performance data for one class cannot properly be compared to actual performance data for another class. Even if Priority Mail were to meet its two day service standard 80% of the time, for example, that still may be better service than is received by another subclass which meets a far less stringent service standard 90% of the time; and

2. In any event, there are no studies that reliably measure door-to-door delivery performance for Priority Mail or for most other subclasses.

NDMS also argues that Priority Mail's market share has been in decline. NDMS Brief at 65. But even assuming accurate market share information were available -- and it is not -- relative market share is not one of the statutory non-cost factors. Nothing in the Postal Reorganization Act suggests that any of the Postal Service's products should be guaranteed any particular market share. Market share is therefore irrelevant to determining the proper assignment of the Postal Service's institutional costs. Indeed, sections 3622(b)(4) and 3622(b)(5) of the Act suggest that the Commission should not be concerned about maintaining the Postal Service's position in a market so long as mailers have available to them adequate alternatives to the Postal Service.

The fact that Priority Mail may not offer certain service features that are offered by the Postal Service's competitors (see NDMS Brief at 66) is likewise irrelevant to the appropriate markup for Priority Mail. As the Postal Service's ubiquitous Priority Mail advertising shows, Priority Mail's rates are substantially below those of its competitors, at least for the vast majority of Priority Mail volume weighing two pounds or less. That is not surprising, since the Postal Service's own regulations *require* its competitors to charge twice as much as Priority Mail rates in the case of letter shipments, which constitute a substantial proportion of Priority Mail volume.

The primary determinant of the appropriate cost coverage for Priority Mail is and should be the relationship between its markup and that for First Class mail. Dr. Henderson's proposed cost coverage of 193% maintains the Commission's established markup relationship. Tr. 25/13569. The record does not contain any evidence of any substantial change since Docket No. R94-1 which justifies a departure from the Commission's established markup relationship. On the contrary, if anything, Priority Mail's cost coverage should increase relative to that for First Class mail, since delivery confirmation service will soon be available to Priority Mail but not to First Class mail.

Accordingly, the Commission should adopt Dr. Henderson's cost coverage and rate increase recommendation for Priority Mail.

#### B. Parcel Post

The Parcel Shippers Association ("PSA") argues that Parcel Post rates should not be increased at all, or, at most, should be increased only by the systemwide average increase. PSA Brief at 36-37. PSA persists in arguing that Parcel Post rates should be depressed to the lowest possible level "because there is a lack of competition in the market and a lack of regulation of UPS." PSA Brief at 12-13. However, the Postal Reorganization Act is intended to regulate the Postal Service, not UPS; it is Congress, not PSA, that decides who should and should not be regulated.

PSA's claims that "there is a lack of competition in the market" and that UPS is "dominant" with respect to the delivery of parcels to residences (Brief at 12, 13) is flatly contradicted by all of the evidence in the record. The record shows that there are many carriers which deliver to residences, including not only nationwide businesses such as the Postal Service, UPS, and Federal Express (see Tr. 20/10228, 24/13056-57, 25/13616), but also regional and local carriers that can be -- indeed, that

have been -- woven together into a national network by consolidators such as CTC Distribution Services and by nationwide shippers such as Avon.<sup>12</sup>

PSA complains (Brief at 13) that the Commission cannot "make a judgment" on the parcel delivery market (including parcels of all types) because the Commission has (correctly and repeatedly) refused to require UPS to supply proprietary information on its volume by weight. See Presiding Officer's Ruling No. R97-1/104 (February 27, 1998). But, as we have already stated, it is not the Commission's job to "make a judgment" on the market. In any event, PSA apparently is unaware that the record does contain evidence on the entire parcel delivery market, and the evidence shows that the Postal Service is the dominant carrier of parcels of all types to residences. Tr. 36/19845-47, 19854-55. Even PSA's own survey shows that the Postal Service is fast becoming the dominant force for the delivery of small parcels to residences. Tr. 24/12947-48, 12951 (survey showing that, of PSA's responding members, the Postal Service delivers 45% and other carriers deliver an additional 9% of the parcels sent to residences). Yet, PSA refers in its brief to an alleged but fictitious "increasing dominance of UPS." PSA Brief at 15.

PSA argues that reducing Parcel Post's test year after rates attributable costs by \$75,609,000 of intra-Alaska non-preferential air transportation costs and adopting the Postal Service's proposed cost coverage of 104% leads to the result that there should be no rate increase at all for Parcel Post. PSA Brief at 20. Even

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12. CTC witness Clark testified that he uses seven carriers on a regular basis to make deliveries to residences, and that during all of 1997 he used as many as seventeen carriers to make residential deliveries. Tr. 20/10208, 10216, 10232-33. Similarly, Avon has successfully created a nationwide network of 31 carriers for the delivery of its products to residences. Tr. 24/13074, 13077. PSA's own assertion that "at one time Avon was UPS' single biggest customer" (PSA Brief at 14) (emphasis added) serves only to show that UPS is not nearly as "dominant" as PSA would have the Commission believe.

assuming the correctness of PSA's calculations, its conclusion also requires the Commission to adopt Dr. Bradley's mail processing labor cost variabilities. See Tr. 25/13620.

As stated in UPS's initial brief, a Parcel Post cost coverage of 107% is dangerously low. It is just such razor thin cost coverages that have resulted in a checkered history of below cost rates for Parcel Post. Dr. Henderson's proposal to maintain Parcel Post's cost coverage at the level established in Docket No. R94-1 is the minimum acceptable result.

**VI. THE POSTAL SERVICE'S PROPOSED PARCEL POST DISCOUNTS AND RATE DESIGN SHOULD BE MODIFIED AS RECOMMENDED BY MR. LUCIANI.**

The Postal Service launches a number of attacks on Mr. Luciani's recommendations concerning the proposed worksharing discounts and rate design changes put forth by the Postal Service. All of those challenges should be rejected.

1. The Postal Service argues that Mr. Luciani's recommendation to treat intra-BMC intermediate transportation costs as partially distance related is based solely on rate design considerations and amounts to "doctoring cost data." Postal Service Initial Brief at V-189. The fact of the matter is that Mr. Luciani's recommendation is not based only on the significant rate anomalies caused by treating all intra-BMC intermediate costs as not distance related, but rather is also based on the fact that, from a cost causation standpoint, some portion of intra-BMC intermediate transportation costs are certainly distance related, Tr. 26/14321-22, as Postal Service witness Hatfield himself recognized. USPS-T-16 at 10.

2. The Postal Service asserts that the record does not contain any "clear" dollar figure to correct the double-counting of avoided acceptance costs pointed to by Mr. Luciani, and that Mr. Luciani subtracts ASF costs twice by failing to account for the fact that Mr. Sellick's platform acceptance costs include ASF costs. Postal



Service Initial Brief at V-191, V-193. The fact is that Mr. Luciani and Mr. Sellick do provide a "clear" dollar figure to correct both the avoided acceptance cost double-count and Mr. Crum's erroneous inclusion of mail preparation costs in his estimates of DBMC avoided costs. See Exhibit UPS-T-4A, Tr. 26/14336.<sup>13</sup> Moreover, in making his ASF correction, Mr. Luciani used Ms. Daniels' work flow model to derive ASF costs. Tr. 26/14296. Ms. Daniels' model does not include platform acceptance costs or the facing, edging, culling, and rewrapping operations associated with mail preparation costs. See USPS-T-29, Appendix V. Therefore, Mr. Luciani's ASF adjustment would not result in a double deduction of these costs.

3. The Postal Service argues that Mr. Luciani "has shown that DBMC saves almost 8 cents per piece at BMCs" while the Postal Service has conservatively assumed these savings to be zero, "more than offsetting the less than 2 cents" per piece which Mr. Luciani deducts from avoided costs to account for the fact that ASFs often function as BMCs. Postal Service Initial Brief at V-194 (citations omitted). The fact is that Ms. Daniels specifically noted that her analysis was performed "for the sole purpose of comparing an average Parcel Post model cost to the CRA parcel post mail processing cost pools." USPS-T-29, Appendix V at 10-12 (emphasis added). Thus, that analysis does not take account of the much lower density of DBMC parcels, and thereby does not reflect the different, higher cost of DBMC parcels. Tr. 35/19004; USPS-T-16 at 14. If the asserted DBMC savings of almost 8 cents per piece were corrected to take into account the much lower density (and therefore the higher cost) of DBMC mail, there would likely be only a minimal difference between the cost of

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13. The platform acceptance element of the combined overstatement may be calculated separately from Exhibit UPS-T-4A to Mr. Luciani's testimony, Tr. 26/14336, and Mr. Sellick's workpaper LR-UPS-Sellick-1-IV-A, page 1. It comes to 1.8 cents per piece. Id.

processing DBMC parcels at BMCs and the cost of processing other parcels at BMCs. Moreover, the Postal Service ignores the fact that, as Mr. Luciani noted in his testimony (Tr. 26/14296), Ms. Daniels' estimate of the costs incurred "upstream" of the BMC (i.e., between the origin facility and the destination BMC) -- the very costs which DBMC entry avoids -- is much lower than the cost savings that Mr. Crum estimates for DBMC. The Postal Service's selective reliance on Ms. Daniels' analysis to support its argument that Mr. Crum's cost avoidance calculation is conservative should be rejected.

4. The Postal Service argues that Mr. Crum's DSCF and DDU cost avoidance estimates are conservative because Mr. Crum chose "not to apply a CRA adjustment factor (non-modeled cost factor)" in arriving at his estimates. Postal Service Initial Brief at V-197. The Postal Service never raised, either on cross-examination of Mr. Luciani or in its rebuttal testimony, any claim that a CRA adjustment factor should be applied to Mr. Crum's DSCF and DDU avoided cost estimates. Since there is no testimony in the record supporting this assertion, first made on brief, it must be rejected as unsupported, especially since UPS has not had an opportunity to rebut this claim. As an example that this claim is suspect, UPS notes that Ms. Daniels did not model platform acceptance costs; this omission increases her CRA adjustment factor from what it otherwise would be. However, platform acceptance costs are included in Mr. Crum's DBMC, DSCF, and DDU cost avoidance calculations. Grossing up Mr. Crum's calculated savings by a factor intended to reflect the exclusion of platform acceptance costs from Ms. Daniels' model is a clear double count, since those costs were already taken into account by Mr. Crum in his separate cost avoidance analysis. Moreover, a CRA adjustment factor would not apply to the transportation component of the estimated cost savings.

5. The Postal Service claims that Mr. Crum's avoided DBMC costs are understated because, as Mr. Luciani "correctly notes," DBMC parcels are larger in cube (less dense) than non-DBMC parcels, so that Mr. Crum's calculation of the cost

difference between DBMC parcels and non-DBMC parcels must be understated (because his estimate is based on smaller, higher density pieces where the cost difference between DBMC parcels and non-DBMC parcels would be smaller). Postal Service Initial Brief at V-198. The fact is that even assuming that the Postal Service is correct and that the discount should be bigger for the reason it gives, the base rate from which the discount would be deducted should then be higher to reflect the additional costs incurred both upstream and downstream of the BMC as a result of the lower density of DBMC parcels compared to the average parcels on which Mr. Crum's estimate is based.

6. The Postal Service asserts that at least some mail entered at a co-located delivery unit may be entered as DSCF mail, and that therefore Mr. Luciani has understated the local transportation costs that DSCF mail will avoid. Postal Service Initial Brief at V-200-01. If the Postal Service's contention is true (though it seems to be contrary to the Postal Service's prior interrogatory responses, see Tr. 19/9555), Mr. Hatfield's DSCF transportation costs would not be understated by 12.3%, but they would be understated by some lesser amount. On the other hand, more costs would then be incurred to process the DSCF parcels entered at the co-located DSCF, thereby reducing the 31.4 cents per piece of avoided processing costs estimated by Mr. Crum for DSCF entry. Thus, if the Postal Service's contention on brief is right, then Mr. Crum is wrong; both cannot be right. Regardless of which of the two assumptions are used, the Postal Service has overstated either the transportation costs or the non-transportation costs avoided by DSCF entry.

7. The Postal Service mischaracterizes Mr. Luciani's position when it states that he "maintain[s] that there are no non-modeled costs to justify the use of a non-modeled cost factor" in the case of the proposed prebarcode discount. Postal Service Initial Brief at V-205. Mr. Luciani did not testify that there are no non-modeled costs; rather, he testified that there would be few such costs, and that those few costs

would not be relevant to the cost difference between scanning a prebarcoded piece and keying in a non-prebarcoded piece. Tr. 26/14307. In particular, he testified that there is no evidence that whatever non-modeled costs may exist would be incurred to a greater extent by non-prebarcoded pieces than by prebarcoded pieces. Id.

8. The Postal Service argues that "several" of Mr. Luciani's reasons for recommending reduced worksharing passthroughs ignore Mr. Hatfield's transportation testimony, which, it claims, explains "the differences in the transportation cost estimates between Docket No. MC97-2 and the current docket." Postal Service Initial Brief at V-209. The fact is that even assuming the Postal Service is correct, this does not explain the substantial differences between the non-transportation avoided cost estimates presented in Docket No. MC97-2 and those presented here. More important, regardless of the merits of these few points, the Postal Service does not even attempt to deal with the many other uncertainties cited by Mr. Luciani in his testimony. See Tr. 26/14312-16. In light of those uncertainties, the Commission should continue to follow its well-established practice of recommending conservative passthroughs -- in the neighborhood of 75% -- for new discount proposals such as those proposed here for Parcel Post.

VII. THE NEED FOR A SURCHARGE ON PRIORITY MAIL PARCELS IS CLEAR.

Mr. Sellick and Mr. Luciani have testified that, according to the Postal Service's own data, it costs approximately 19.5 cents per piece more to process Priority

Mail parcels than to process Priority Mail flats.<sup>14</sup> That testimony has not been rebutted by any witness.

The Postal Service argues that Mr. Luciani "ignores the impact of the PMPC contract on Priority Mail processing costs." Postal Service Initial Brief at V-113. That is just not so. Mr. Luciani specifically testified that his recommended surcharge is buttressed by the fact that, under the PMPC contract, the Postal Service pays the contractor different prices to process parcels as opposed to flats. Tr. 26/14329. The impact of the PMPC contract on the relative costs of processing parcels and flats is also discussed in UPS's Supplemental Brief Filed Under Seal Pursuant to Presiding Officer's Ruling No. R97-1/62 (April 1, 1998).<sup>15</sup>

NDMS argues that Mr. Luciani's recommendation is "yet another example of a shape-based surcharge proposal which lacks sufficient underlying information regarding the cost relationship between weight and shape." NDMS Brief at 62. NDMS apparently does not dispute the unrebutted evidence that parcels cost 19.5 cents more per piece to process than flats. Thus, the fact is that the existing rate design does not adequately reflect the additional cost of processing parcels.

In short, it is clear beyond doubt that the Priority Mail parcel surcharge recommended by Mr. Luciani is warranted and should be adopted by the Commission.

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14. The surcharge of 10 cents per piece is calculated by decreasing the 19.5 cents per piece cost difference to reflect the fact that Priority Mail parcels weigh more than flats and therefore already pay, on average, 9.3 cents per piece more than flats because the Priority Mail rate design includes an additional charge per pound to reflect increased processing costs. See Tr. 26/14329-30.
  15. In light of the Postal Service's erroneous assertion, UPS is filing under seal a Supplemental Reply Brief addressing that claim.

VIII. **THE POSTAL SERVICE'S FLAGRANT ATTEMPT TO  
SUBSIDIZE DELIVERY CONFIRMATION SERVICE FOR  
LARGE PRIORITY MAIL USERS MUST BE REJECTED.**

The Postal Service proposes to provide, free of charge, the new delivery confirmation special service to certain favored customers only. It attempts to minimize the blatant cross-subsidy that would result from its proposal by arguing that the subsidy amounts to only one cent per piece extra for all Priority Mail shipments. But that is not the correct measure of the subsidy. The relevant fact is that the subsidy amounts to almost 15 cents per piece for large volume Priority Mail delivery confirmation users, because that is the cost of providing delivery confirmation service to those users which would be shifted from them to all Priority Mail users. Under the Postal Service's reasoning, it would be acceptable to shift all of Parcel Post's incremental costs as estimated by Dr. Takis (a little under \$761 million) to First Class mail, for example, because doing so would only add less than one cent per piece to the rates for each piece of First Class mail.<sup>16</sup>

The Postal Service also argues that Mr. Luciani's proposal to distribute all of the volume variable costs of the scanner program to Priority Mail and Standard B mail on the basis of revenue should be rejected because "each [carrier] route will be assigned a dedicated scanner, [so that] scanner costs vary in proportion to the number of carrier routes." Postal Service Initial Brief at VI-21. But the fact of the matter is that delivery confirmation service will be available only for users of Priority Mail or Standard B mail, not for all classes of mail. Given this undeniable fact, it is just plain wrong to

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16. Dr. Takis shows test year after rates incremental costs for Parcel Post of \$760,898,000 and 1998 First Class mail volume of 101,074,030,000 pieces. Exhibit USPS-41B. Dividing Parcel Post's incremental costs by First Class mail's volume yields an increase of 0.75 cents per piece for First Class mail.

allocate only \$421,000 of the volume variable scanner costs of \$51.9 million to Priority Mail and only \$184,000 of these costs to Parcel Post, while First Class mail picks up more than \$12.6 million of those volume variable costs. Tr. 3/1308-09.<sup>17</sup>

The sole basis for the Postal Service's fee structure is that large volume Priority Mail users just do not want to pay extra for the costs of delivery confirmation service. See Tr. 35/19045-46, 19051. That is no justification for requiring other mailers to pay these costs.

The Postal Service suggests that its proposal is no different from the approach followed by its competitors, some of whom "already offer delivery confirmation as a part of the base product." Postal Service Initial Brief at VI-15. There is a big difference. When delivery confirmation is indeed a standard feature of the "base product," all users receive the service at no extra charge. However, under the Postal Service's proposal, only some users would receive the service free of charge, while other users would pay for it.

This type of discrimination is exactly what Congress intended to prohibit when it adopted sections 403(c), 3622(b)(1), and 3623(c)(1) of the Postal Reorganization Act.

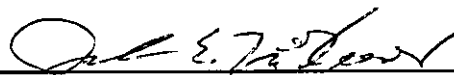
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17. Mr. Luciani's proposal to distribute all of the volume variable costs of the scanner program to Priority Mail and Standard B mail is modest. The vast majority of the scanner program costs are *not* volume variable. Those costs -- amounting to \$131.1 million, Tr. 26/14333 -- would continue to be spread across all classes of mail as institutional costs, to reflect the fact that the scanner program would have uses other than providing delivery confirmation service.

## CONCLUSION

There is nothing in the briefs of the Postal Service and of the other parties which undercuts the conclusions of UPS's witnesses. Accordingly, the Commission should adopt the recommendations set forth in UPS's initial brief.

Respectfully submitted,



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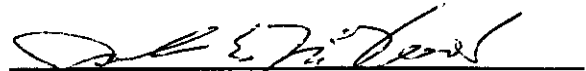
Of Counsel

Dated: April 10, 1998



CERTIFICATE OF SERVICE

I hereby certify that I have caused to be served the foregoing Brief of United Parcel Service upon all participants of record in this proceeding on this date in accordance with Section 12 of the Rules of Practice.

  
John E. McKeever

Dated: April 10, 1998